LIBRARY
SUPREME COURT, U. S.

Supreme Court, U. S.
FILED
FEB 5 1976
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1975

No. 75-808

ANTHONY M. NATELLI,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

KENNETH J. BIALKIN
Attorney for Amicus Curiae
American Institute of Certified
Public Accountants
1 Chase Manhattan Plaza
New York, New York 10005

Of Counsel:

HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
New York, New York 10005

TABLE OF CONTENTS

	PAGE
Opinions Below	1
Question Presented	2
Interest of the Institute as *Amicus Curiae*	2
Statement	3
Argument	8
POINT I—Certiorari should be granted to clarify the duty of an accountant with respect to unaudited financial statements with which he is associated	8
A. The Charge As A Whole Totally Distorted The Role Of An Accountant With Respect To Unaudited Financial Statements	9
B. The Jury Charges Are Inconsistent With The Court Of Appeals Analysis	11
C. The Petition Should Be Granted To Eliminate The Confusion Resulting From The Opinion Of The Court Of Appeals Affirming The Charge To The Jury And To Firmly Establish A Standard Of Conduct In An Area Important To The Conduct Of Financial Affairs In Light Of The Securities Laws	13
POINT II—An accountant should not be criminally liable merely because he has knowledge of suspicious circumstances	14
CONCLUSION	17

TABLE OF AUTHORITIES

PAGE

Blue Chip Stamps v. *Manor Drug Store*, 43 U.S.L.W. 4707, (U.S. June 9, 1975) 15

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) *(en banc)*, *cert. denied*, 349 U.S. 976 (1969) 15

United States v. *Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied sub nom. Howard* v. *United States*, 377 U.S. 993 (1964) 7, 16

United States v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) 7, 16

Ultramares Corp. v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931) 15

Burton, Fairness: Another View, Changing SEC Financial Disclosure and Rules—1975 (New York Law Journal 1975) 16

AICPA, Statement on Auditing Standards No. 1—Codification of Auditing Standards and Procedures (1972)—

§ 110.01 9
§ 320 9
§ 330 9
§ 516 ..... *passim*
§ 630.17 7

AICPA, Statement on Auditing Standards No. 2 (1974) 6

IN THE

Supreme Court of the United States

October Term, 1975

No. 75-808

ANTHONY M. NATELLI,

Petitioner,

against

UNITED STATES OF AMERICA,

Respondent.

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

Upon the consent of Petitioner and Respondent, the American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae,* addressed to certain issues specified below, and urges this Court to grant the petition of Mr. Anthony M. Natelli for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Opinions Below

The opinions of the United States Court of Appeals are annexed to the Petition for a Writ of Certiorari as Appendices A, B and C and to Petitioner's Supplemental Brief as Appendix A.

Question Presented

The Institute, as *amicus curiae,* addresses this brief solely to the first question presented by Petitioner.[1] That issue may be restated as follows:

May an independent public accountant be criminally convicted for violation of Section 32(a) of the Securities Exchange Act of 1934 on an indictment containing a specification that he made or caused to be made false and misleading statements in an unaudited financial statement contained in a proxy statement where the accountant had no actual substantive knowledge of the falsity of the unaudited financial statement and where the district court refused to charge that the duty of an accountant with respect to unaudited financial statements differs from his duty with respect to financial statements he had been engaged to audit.

Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 110,000 members. Among its purposes is the promotion and maintenance of high professional standards of practice and, in the pursuit of that purpose, the Institute has come to be accepted as the authoritative source of auditing standards and procedures in its field. Most particularly, the Institute develops the professional auditing standards which, after widespread exposure to its members, government and regulatory agencies, business entities and other interested persons, and formal approval by vote of its Auditing Standards Executive Committee,

[1] The Institute has not formulated and does not express a position with respect to any of the other issues presented by Petitioner.

are deemed "generally accepted" and which form the backdrop of this litigation.[2]

The Institute consequently has an obvious interest in the scope of criminal liability that is sought to be imposed on independent public accountants with respect to unaudited financial statements. That interest in this case transcends the usual interest of a professional association. Here the district court expressly refused to charge the jury with respect to the differences in an accountant's duty pertaining to audited and unaudited financial statements, despite the clear and compelling distinctions in professional responsibility as reflected in the Institute's SAS No. 1 § 516. On appeal the Second Circuit attempted to interpret SAS No. 1 § 516, but failed to correct the doctrinal chasm breached by the district court and added a new standard of suspicion not found in accounting literature. Thus, the issue addressed here has significance going far beyond the interests of the parties litigant and its resolution impacts the standards adopted by the Institute and concerns every member of the Institute and the accounting profession as a whole, already deeply concerned with the continuing task of meeting the evergrowing demands of the business community and investigating public for meaningful financial information at manageable cost.

Statement

Petitioner was indicted for having "wilfully and knowingly made and caused to be made false and misleading statements with respect to material facts" contained in a proxy statement of National Student Marketing Corpora-

[2] *See, e.g.*, AICPA, Statement on Auditing Standards No. 1—Codification of Auditing Standards and Procedures (1972) (hereinafter "SAS No 1").

tion ("NSM") dated September 27, 1969. Two specifications were contained in the count relevant to Natelli: (1) *specification relating to audited statements* — insufficient disclosure in a footnote to the audited financial statement contained in the proxy statement reconciling NSM net sales and earnings for the year ended December 31, 1968 as originally reported upon by Peat, Marwick, Mitchell & Co., with restated amounts shown in the statement of earnings contained in the proxy statement; and (2) *specification relating to unaudited statement*—the proxy statement contained a false unaudited statement of NSM earnings for the nine months ended May 31, 1969. Natelli was a partner of Peat, Marwick, Mitchell & Co., in charge of its Washington, D. C. office and the Peat, Marwick partner in charge of the NSM engagement.

The Petition contains a statement of the facts adduced at trial pertaining to each specification. It is sufficient to note here the principal fact relevant to the issue addressed by the Institute: it appears that Natelli did not have actual subjective knowledge that the unaudited NSM financial statement was false.

Both specifications of the single count of the indictment relevant to Natelli were presented by the district court to the jury on a theory that the jury should determine whether Natelli should have known that the footnote or the unaudited financial statement was false. The district court charged:

> "While I have stated that negligence or mistake do not constitute guilty knowledge of intent, nevertheless, ladies and gentlemen, you are entitled to consider in determining whether a defendant acted with such intent if he deliberately closed his eyes to the obvious *or to the facts that certainly would be observed or ascertained in the course of his accounting work* or whether he recklessly stated as facts matters of which he knew he was ignorant.

> If you find such reckless deliberate indifference to or disregard for truth or falsity on the part of a given defendant, the law entitles you to infer therefrom that that defendant wilfully and knowingly filed or caused to be filed false financial information of a material nature with the SEC.
>
> But such an inference, of course, must depend upon the weight and credibility extended to the evidence of reckless and indifferent conduct, if any.
>
> I repeat: Ordinary or simple negligence or mistake alone would be insufficient to support a finding of guilty knowledge or wilfullness or intent." App. I 2364-5 (Emphasis added)[3]

The court further charged, upon being requested by the jury during the course of its deliberations, that the instructions be repeated:

> "In this regard I went on to say parenthetically that outside auditors such as Peat, Marwick, Mitchell of course have no responsibility for the operations of management of a company such as NSMC.
>
> On the other hand, an auditor *must* ascertain when he is working on materials such as a proxy statement for a company that the financial statement in question, including such figures which are relevant or a footnote or footnotes that might be relevant contained therein, fairly present the results of the operations and the financial position of that accounting firm's client. Also an auditor *must* honestly believe that the financial statement is neither false nor mis-

[3] References denominated "App." are to the Appendix before the Second Circuit.

> leading in respect to material fact as I have defined material fact." App. I 2397-98 (Emphasis added).[4]

As further discussed under Point I, there is a vast difference between the accountant's professional duty concerning statements he is to audit and concerning unaudited statements. With respect to audited statements his duty is that set forth in his report:

> "We have examined the balance sheet of X Company as of (at) December 31, 19XX, and the related statements of income, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.
>
> "In our opinion, the financial statements referred to above present fairly the financial position of X Company as of (at) December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." AICPA Statement on Auditing Standards No. 2 (1974)[5]

With respect to an unaudited statement, he has no independent duty to ascertain or report on its accuracy. A duty

---

[4] A similar charge was given at App. I 2369.

[5] The Institute notes, in addition to the point made *infra*—namely, that the charge to the jury distorted an accountant's duty with respect to unaudited financial statements—that the charge erroneously states the role of an accountant with respect to *audited* statements. The financial position of a company, as noted in the text at note 14 *infra*, is not the finite certainty implied by the word "ascertain" employed by the district court. An accountant's role is judgmental as stated in the words of his opinion noted above.

only arises if he is aware that the unaudited financial statement is not in conformity with generally accepted accounting principles.[6]

Natelli, therefore, requested that the unaudited statement specification be dismissed and, failing that, requested the district court to charge the jury that

> "As to the unaudited statement of earnings for the nime months ended May 31, 1969, the defendants had no responsibility to render an opinion that the statement fairly presented the results of the client's operations. The defendants' only responsibility as to this statement was to be satisfied that, as far as they knew, the statement contained no misstatement of material facts." App. I 209.

That request was repeated on several occasions. *E.g.*, App. I 2384. The district court refused to give that charge or any other distinguishing an accountant's duty with respect to unaudited financial statements from his duty with respect to financial statements he has been engaged to audit. App. I 2384.

The jury returned a general verdict of guilty, thus making it impossible to know whether conviction was based on specification 1 or 2 or both. On appeal, the Second Circuit affirmed Natelli's conviction. The Opinion of the Court of Appeals is Appendix A to the Petition for Certiorari.

---

[6] SAS No. 1 § 516.06. In instances involving an underwriter or an acquisition, an accountant is often asked to provide a "comfort letter" prepared on the basis of certain procedures he contractually agrees to perform. But even there he gives a negative assurance, stating for example that nothing has come to his attention which would indicate that the unaudited statement is not in conformance with generally accepted accounting principles. SAS No. 1 § 630.17.

ARGUMENT

POINT I

Certiorari should be granted to clarify the duty of an accountant with respect to unaudited financial statements with which he is associated.

This Court is now called upon to consider the standards applicable to the criminal liability of an independent public accountant under Section 32(a) of the Exchange Act with respect to *unaudited* financial statements. That issue is one never before considered by this or any other federal court.[7]

While the indictment was framed on the theory that Natelli knew of the falsity of the unaudited financial statement of NSM, the uncontradicted facts presented at trial, and the apparent assumption of both parties, demonstrate that he had no actual knowledge that the unaudited statement was false.[8] Thus, the issue here turns on the question of whether the jury was adequately instructed in considering if Natelli should have known of the falsity of that unaudited financial statement.

The jury's determination was made on the basis of charges which the Institute contends seriously distorted the role and duty of an accountant with respect to unaudited financial statements. Those charges violated the cogent and carefully drawn standards of the Institute, particularly SAS No. 1 § 516. That defect was not corrected by the Court of Appeals; the *dicta* that it was not

---

[7] *United States* v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) and *United States* v. *Benjamin*, 328 F.2d 854 (2d Cir.), *cert. denied sub nom. Howard* v. *United States*, 377 U.S. 993 (1964), cited by the court below, involved audited financial statements.

[8] See the statement of the District Court at App. I 284.

changing the applicable standard[9] was internally inconsistent with its holding insofar as it did not reverse and vacate the judgment of the district court. Had the Court of Appeals fully applied the language of its own opinion to the district court's charge, it would have had no alternative but to reverse. Its failure to do so inserted a serious confusion in the law applicable to the conduct of accountants with respect to unaudited statements. That confusion in this important area of concern to all accountants and their clients, should be resolved by this Court, particularly since the district court's standard enjoys not a shred of support in accounting literature or law.

A. The Charge as a Whole Totally Distorted the Role of an Accountant With Respect to Unaudited Financial Statements

It is elementary that when an accountant undertakes to *audit* financial statements, he accepts the duty of performing an examination of the books and records of the client and of performing various auditing steps testing the entries on those books and records in order to express an opinion on the fairness with which the financial statements present the financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles. *E.g.,* SAS No. 1 § 110.01. This involves development of an extensive audit program and requirements for testing and confirmation as reflected in the detailed professional standards articulated in the Institute's pronouncements. See SAS No. 1 §§ 320, 330.

But an accountant undertakes no such professional duty with respect to an unaudited financial statement with which he is associated.[10] An independent duty arises only

---

[9] Pet. for Cert. App. A at 24(a).

[10] An accountant is associated with unaudited financial statements of a client if he permits his name to be used any place in a document containing them. SAS No. 1 §§ 516.03, 516.11, 516.12.

if he learns that the unaudited financial statement does not conform with generally accepted accounting principles. This sharp distinction in duty is set forth in SAS No. 1 § 516.06. It provides:

> "Because unaudited financial statements, by definition, have not been audited by the certified public accountant, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist (except under the conditions described in paragraph .05) upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements."

Thus, the accountant has no duty of verification with respect to unaudited financial statements. Although he may not consciously blind himself to the obvious, a duty of insistence upon revision or disclosure arises only if he concludes that generally accepted accounting principles were not observed.

This difference in kind was blatantly misconstrued by the district court. As noted, the jury was charged that it could find knowledge if it found that Natelli [a] "deliberately closed his eyes to the obvious or [b] to the facts that certainly would be observed or ascertained in the course of his accounting work or [c] whether he recklessly

stated as fact matters of which he knew he was ignorant." App. I 2364.

The district court failed to draw any distinction in duty between the footnote to the audited statements and the unaudited nine months statement and failed to distinguish a duty to investigate from a duty based on awareness. Instead, the district court presented the jury with a test of the three alternatives noted above, any one of which it charged would suffice to give knowledge. The second alternative, referring to "facts that certainly would be observed or ascertained in the course of his accounting work," expressly states and could have been interpreted by the jury only to mean that Natelli had a pre-existing obligation to perform "accounting work" with respect to the NSM unaudited financial statement. That implication and the nature of that "accounting work" the court made explicit. It charged that "an auditor must ascertain when he is working on materials such as a proxy statement . . . that the financial statement in question . . . fairly present[s] the results of the operations and the financial position of that accounting firm's client" and refused to charge that an accountant had a different duty with respect to unaudited financial statements, as noted above.

The district court's charge, therefore, enjoys no warrant in the professional standards applicable to accountants. Instead, it obliterated the obvious differences in professional duty with respect to unaudited and audited financial statements made plain in SAS No. 1 § 516 and thereby dramatically changed an accountant's duty with respect to unaudited financial statements.

B. The Jury Charges are Inconsistent With the Court of Appeals

Strangely, the charge of an independent duty with respect to unaudited financial statements is also inconsistent

with the very opinion of the Court of Appeals which sustained Natelli's conviction.

The Court of Appeals stated that:

> "In the ordinary case involving an unaudited statement, the auditor would not be chargeable simply because he failed to discover the invalidity of booked accounts receivable, inasmuch as he had not undertaken an audit with verification." *Pet. for Cert.* App. A at 16a.

It then relied on SAS No. 1 § 516.06 to find that a duty may arise when it is shown that the accountant knows that the unaudited financial statement was not in conformity with generally accepted accounting principles.[11]

Despite its recognition that an accountant has no independent duty with respect to unaudited financial statements, the court below failed to appreciate that the district court's charge incorporated a duty which the jury could have understood to be equivalent to an audit. As noted it combined its instructions for the footnote to the audited financial statement with those for the unaudited interim statement. In so doing, the district court necessarily assumed such an independent duty, namely, the performance of some "accounting work" with respect to unaudited financial statements and a duty to ascertain fair presentation.

The charge was, therefore, inconsistent with the opinion of the Court of Appeals analysis and the judgment should have been reversed. Under that analysis, Natelli was entitled to have a jury know that he had no independent duty

---

[11] The Court of Appeals, however, interpreted SAS No. 1 § 516.06 to equate suspicion with knowledge. The impropriety of a suspicion standard is addressed in Point II *infra*.

to investigate or confirm the NSM unaudited financial statement, in deciding whether Natelli had the requisite knowledge to impose on him a duty of inquiry. Further, under that analysis, the jury had to determine if the true facts were in the scope of inquiry and whether the duty was criminally breached. The issue of whether Natelli had such a duty, however, was taken from the jury by the district court's charge.

C. The Petition Should Be Granted to Eliminate the Confusion Resulting From the Opinion of the Court of Appeals Affirming the Charge to the Jury and to Firmly Establish a Standard of Conduct in an Area Important to the Conduct of Financial Affairs in Light of the Securities Laws

The Petition for Certiorari should thus be granted, not only because a disturbing circumstance is raised since the charge to the jury is inconsistent with the professional standards applicable to Natelli and inconsistent with the opion which affirms it, but because the state of the law in this area has now been reduced to utter confusion.

Presumably, unless *certiorari* is granted, accountants in future cases could now be subject to criminal liability on the charges submitted to the jury below since those charges were sustained by the Court of Appeals. Yet, since those charges are inconsistent with the analysis of the Court of Appeals and with the professional standards, clarification is required. No accountant should have to be put to the uncertainty now extant and no court should have to elect between the charges sustained here and the language sustaining them. The Petition should be granted, if for no other reason, in order to lend certainty to this area.

Furthermore, since the issue here is of paramount concern to accountants and directly affects their performance

on nearly every financial statement filed with the SEC involving unaudited financial statements, the dramatic change in professional duty incorporated in the district court's charge should be considered by this Court before it becomes the standard applicable to such statements. That consideration is particularly required in this case since neither the Exchange Act nor its legislative history contains a single indication that Congress ever desired to enact the standard promulgated by the district court and approved by the Court of Appeals. Moreover, not even the SEC, even assuming it has power to make such a rule under Section 23 of the Exchange Act, has incorported the district court's improvident standard. The continued viability of that standard, therefore, demands this Court's attention and review.

POINT II

An accountant should not be criminally liable merely because he has knowledge of suspicious circumstances.

Instead of requiring actual knowledge of the falsity of an unaudited financial statement filed with the SEC, the court below held that an accountant could be convicted of criminal fraud on the basis that he knew that the unaudited financial statement contained suspicious figures. It interpreted the knowledge standard of SAS No. 1 § 516.06 to mean that the accountant "may [not] shut his eyes in reckless disregard of his knowledge that highly suspicious figures, known to him to be suspicious, were being included in the unaudited earnings figures with which he has was 'associated' in the proxy statement." *Pet. for Cert.* App. A at 17a.

This interpretation distorts SAS No. 1 § 516. There, a duty to disclose arises only if the accountant believes

that an unaudited financial statement does not conform to generally accepted accounting principles.

Moreover, suspicion, as a standard upon which criminal liability of accountants, or other professionals is to be based, is too imprecise and overbroad. The most obvious problem inherent in that term is the ability to manipulate it into a conviction for criminal violation of Section 32 of the Exchange Act by attaching its label to data lodged somewhere in the accountant's work papers and applying it to those facts "in the bright gleam of hindsight"[12] after discovery of the fraud of corporate management.

Furthermore, by imposing criminal liability on an accountant for failure to verify items which appear to be highly suspicious in effect imposes liability for negligence. As Chief Judge Cardozo noted in rejecting negligence as a standard of accountant's civil liability to third parties and as this Court recently repeated:[13]

> "The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences. *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441, 444 (1931).

It is the Institute's point that the hazards to be imposed upon accountants by the term "suspicious figures" are so extreme as to cast doubt on the creation of a duty on that basis with respect to unaudited financial statements.

---

[12] *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 867 (2d Cir. 1968) (*en banc*) (Friendly, J. concurring), *cert. denied,* 349 U.S. 976 (1969).

[13] *Blue Chip Stamps* v. *Manor Drug Store,* 43 U.S. L.W. 4707, 4715 (U.S. June 9, 1975).

It is one thing to hold, as in *United States* v. *Simon, supra,* and *United States* v. *Benjamin, supra,* that an existing duty to audit was breached by an accountant who closed his eyes to facts he knew; it is quite another to base the creation of a duty on the basis of suspicion and to impose criminal liability for its breach. Where a duty exists, the accountant knows that he has to satisfy it. But where no such extensive independent duty exists, as in this case of an unaudited statement, the creation of a duty resting on the foundation of suspicion is far too vague and uncertain to serve as a basis for criminal liability.

Thus, the court below should have accepted SAS No. 1 § 516 as it stands The uncertainty of the term "suspicion" and the possible breadth of its scope will have the consequence not only of exposing accountants to criminal liability on a loosely defined concept, but of destroying the differences in duty pertaining to audited and unaudited financial statements. Even in an audit, as the Chief Accountant of the Commission recently observed, "The 'financial position' [of the client] is not an absolute which has been precisely defined or is readily apparent."[14] Accordingly, where an accountant sees an unaudited statement, numerous items might, at first blush, appear to be suspicious. Most life situations contain elements that could engender a healthy suspicion if viewed with a cold eye and uncharitable mien. The possible creation of a duty in such circumstances may therefore result in requiring every accountant to audit all financial statements contained in a document where his name appears.

If a change of that magnitude is to be desired, the Institute submits that it should come from Congress and not

[14] Burton, Fairness: Another View, Changing SEC Financial Disclosure and Rules—1975 (New York Law Journal, 1975).

from the courts below. It cannot fairly be said that investors reading a prospectus could have expected the accountants to have performed such tasks with respect to a statement he did not undertake to audit.[15]

The uncertainty of suspicion as a base for the creation of a duty and the consequences of such uncertainty, none of which were examined by the court below, therefore demand its rejection. *Certiorari* should be granted to address these issues and to eliminate or minimize the risks and consequences implicit in the suspicion standard adopted by the court below.

CONCLUSION

For the foregoing reasons, a Writ of Certiorari should be granted with respect to the first question presented by Petitioner.

Respectfully submitted,

KENNETH J. BIALKIN
Attorney for *Amicus Curiae*
American Institute of Certified
Public Accountants
1 Chase Manhattan Plaza
New York, New York 10005

Of counsel:
HOWARD C. BUSCHMAN III
WILLKIE FARR & GALLAGHER
1 Chase Manhattan Plaza
New York, New York 10005

[15] Indeed, Regulation S-X, Rule 2-02. promulgated by the SEC, is apparently based on this assumption since it requires an accountant to render an opinion only on financial statements he audits.